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LEPOIDEVIN GROUP

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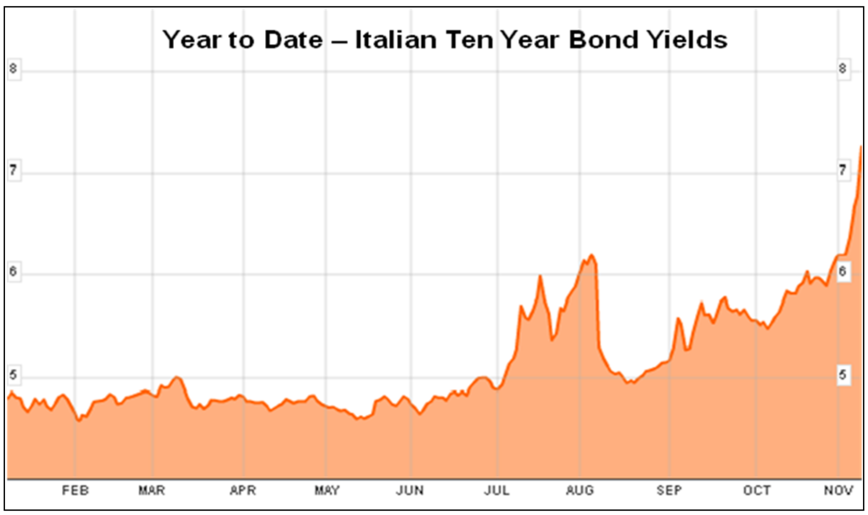
LePoidevin Letter

Europhobia
Redefining Risk



(Source: Bloomberg)

2011 started with strong gains in stocks as investors' sentiment seemed hopeful of a strong economic recovery. The February "LePoidevin Letter," entitled "Investors Overly Optimistic", however, did sound a note of caution: "The current optimistic economic and stock market outlook . . . might just be a good opportunity to take some chips off the table and relocate back to government bonds." And stocks did continue higher until reaching a peak in April; but that caution turned out to be pretty good advice.

Weak economic data, coupled with worries regarding Greece and Europe, sent stocks tumbling and bonds soaring. The Canadian stock market fell 24% by early October -- 19% in the U.S., and as much as 30% to 40% in Europe. Long-term government bond prices jumped 15% as investors sought the safety of bonds.

The fear was not primarily about Greece itself, however, as Greece only makes up 3% of the total European population. Moreover, trade between Canada or the U.S. and Greece is negligible. But the Germans and the French, were especially eager to help ease this turbulence since their banks are loaded with Greek government bonds.

Banks must hold a portion of their assets in reserves held in government bonds. European banking laws had not distinguished between government Euro Dollar debt for Tier One capital calculations. When Greek yields began to rise, European banks could immediately boost profits by trading 2 percent German bonds for 8 percent Greek bonds. The subsequent global stock sell-off was a clear sign that a Greek default could lead to a collapse of the entire European banking system.

October saw the greatest monthly advance in share prices in 9 years. There were hopes that Europe had found a solution to the problem. European banks, it was argued, could "voluntarily" take a 50 percent reduction in the principal amount. Greece would be allowed to owe the banks; but in exchange, Greece would agree to huge spending cuts and tax increases. Despite the wide spread unpopularity of the measure, the alternative would have meant reverting to use of the Greek drachma instead of the Euro and defaulting on their many Euro obligations. If it were to return to the drachma, Greece could have printed all the drachmas it wanted to in order to avoid deep spending cuts; but, of course, those drachmas would have been seen by most as an essentially worthless currency.

Once the Greek government has approved the proposed austerity measures, are the European problems solved? In a word – No! By using 'the back door', and writing down Greek bonds at European banks on a "voluntary" basis, Greece has thus far avoided default. However, in doing so, they have ensured that investors who purchased Credit Default Swaps (CDS) on Greek bonds will not be paid. A CDS is an insurance policy which pays off in the event of default. European banks have voluntarily agreed to a 50% reduction in Greek debts owed to them: so there has yet to be a CDS insurance payoff.

A Reuters news list of the largest issuers of CDS insurance includes:

Barclays
BNP Paribas
Credit Suisse
Deutsche Bank
Societe-Generale
UBS

Bank of America
Goldman Sachs
JP Morgan
Morgan Stanley

If Greece had defaulted, the many banks holding Greek bonds would also have had to pay out billions more to the investors or institutions who had purchased them; and the consequences of Greece's "non-default" can be seen in the current level of Italian bond yields.

Investors who held Greek bonds and also had insurance against default have, thus far, lost out. So when Italy recently proceeded to borrow money by issuing 10-year bonds, yields spiked higher. Many investors and banks that had held some Italian CDS insurance with their Italian bonds, however, no longer trust the CDS market. Greece's actions have now redounded upon Italy as well, and demand for products of Italian bonds has also plunged.

One year ago, there was very little difference in Italian or German bond yield; but Eurodollar investors are no longer treating all governments equally. German 10-year yields are under 2%, whereas Italy's rates are over 6%. Italy has a government debt-to-GDP ratio of about 120%. With a spike in borrowing costs, the next news stories to come out of Europe will surely be about the austerity measures of countries such as Italy, Portugal, and Spain. The immediate risk to Europe may be reduced, but pitfalls remain for the foreseeable future.

With Europe undoubtedly heading for slower growth or even a recession; with recent data showing a slowdown in industrial production in China; and with 54,000 jobs lost last month in Canada, what is an investor to do?

The first place that most investors turn to is high-interest savings accounts or short-term deposits. In the past, I have warned that short-term interest rates rising above long-term rates creates an incentive for investors to park their money in cash, away from stocks and long-term bonds. But currently, we have the opposite rate environment.

With cash yields of just 1% in Canada, and a current inflation rate of 3.2%[1], cash is providing a guaranteed real-return of minus 2.2%. Government of Canada bonds provide yields of just 2.1% for 10-years and 2.8% for 30-years, both below the current inflation rate. This might be a good time, however, to remind investors that interest rates cannot stay at this low rate indefinitely; and when interest rates do rise, bond prices will fall. A 2% rate rise in long-term bonds would equate to roughly a 34% price decline in long-term bonds. So the 2.8% yield is of little consequence when bond prices eventually tank.

Readers of the "LePoidevin Letter" know that for the past 3 years, I have been recommending preferred shares in Canada. Many of my preferred share recommendations have gained 20% to 30% in value, on top of the 5% to 6% dividends since purchase. While some preferred issues remain attractive, other issues are now priced into bubble territory. The preferred shares most vulnerable to price declines are in the fixed-floater sector. Investors who bought these on a new issue basis have been receiving attractive dividends of 4% to 5% for the past two to three years. A risk exists, however, after the 5-year period, when the dividend rate will be reset. If interest rates stay low, the dividend will drop dramatically on the 5-year anniversary of the issue. With many preferred issues due to be reset in 2013, preferred shares are vulnerable to drops of 20% to 30%.

What defines a conservative, balanced, or growth portfolio is asset allocation – in other

[1] www.bankofcanada.ca

words, the percentage of one's funds held in cash, fixed income or stocks. Stocks have historically been viewed as the growth sector (and also the risky sector) of one's portfolio. In the past, cash equivalents such as GIC's would pay an investor 3% above inflation; but as I have pointed out, the current real yield is negative. Long-term government bonds are thus vulnerable to decline at some point.

Many investors are turning to high-yield bonds or bond-funds, which is code for junk bonds. While investors may feel good about seeing a juicy yield, keep in mind that a firm needing to borrow at 8% is not all that safe. Many corporate bonds traded at prices of 50 cents on the dollar in 2008/09, which didn't protect them against market declines. I would suggest that junk bonds are currently overvalued and do not currently reflect the global economic risk.

This leaves me with stocks which encompass a wide range of risk. The lowest risk sector in stocks is consumer staples and utilities. These low risk equities may in fact represent lower risk than many fixed income alternatives.

Furthermore, many companies do not require a robust economy to perform well themselves; and it's this sector of the market that I think is most appealing. Companies like Coke, McDonald's, Johnson & Johnson, Verizon, or General Mills, have been able to achieve decent profit growth while increasing dividends, despite the "great recession."
For clients looking for income, stocks can provide double the yield of government bonds or GIC's; and at the same time provide a growing income-stream through dividend increases.

Johnson & Johnson has a better credit rating than the U.S. government, let alone the Greek or Italian government; so which is safer? U.S. dividend-paying companies just look more appealing at present than do other investment sectors. Fixed-income investments no longer define low risk; nor do equities any longer necessarily define high risk. With this in mind, we continue to set out to build low risk portfolios; we just need to start questioning the old financial planning textbook.

Sincerely,

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